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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 64

LIBSON SHOPS, INC., PETITIONER

v.

GUSTAVE F. KOEHLER, DISTRICT DIRECTOR OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the District Court (R. 32–43) is not officially reported. The opinion of the Court of Appeals (R. 47–60) is reported at 229 F. 2d 220.

JURISDICTION

The judgment of the Court of Appeals was entered on January 19, 1956. (R. 61.) An order denying taxpayer's petition for rehearing was entered on February 16, 1956. (R. 61.) The petition for a writ of certiorari was filed on April 14, 1956, and was granted on June 4, 1956. (R. 62.) The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the taxpayer corporation is entitled, under Sections 23 (s) and 122 of the Internal Revenue Code of 1939, to carry over and deduct from its own income for the taxable year here involved net operating losses sustained in prior taxable years by other corporations which were merged into it.

STATUTE AND REGULATIONS INVOLVED

The statute and Regulations involved are Sections 23 (s), 122 (a), (b) (1) (A) and (2) (C), and (c) of the Internal Revenue Code of 1939, and Section 29.122-1 (a) and (b) of Treasury Regulations 111. These are set forth in the Appendix, *infra*, pp. 48–50.

STATEMENT

The material facts, which the District Court found (R. 33) to be as stipulated by the parties (R. 13–18), may be summarized as follows:

Taxpayer is a Missouri corporation organized in 1946 under the name of Libson Shops Management Corporation. (R. 14, 18.) It engaged in the business of providing management services for sixteen Missouri and Illinois corporations, each of which operated a store selling women's apparel at retail. (R. 14–15.) All of the outstanding stock of taxpayer and of each of the sixteen other corporations was owned, directly or indirectly, by the same eight individuals and in the same proportions. (R. 15.)

On August 1, 1949, pursuant to an agreement for merger under the laws of Missouri and Illinois, the sixteen separate operating corporations were merged

into the taxpayer corporation and dissolved. (R. 15, 30–32.) The merger agreement provided that taxpayer should continue as the surviving corporation under the name Libson Shops, Inc. (R. 22); and that new stock of the taxpayer, in revised amount and par value, should be issued in exchange, *pro rata*, for the stock of the merged corporations. (R. 24–26.) The agreement also enlarged taxpayer's business purposes. (R. 22–24.) After the merger, taxpayer operated the stores which had formerly been operated separately by the sixteen operating corporations, and which now constituted assets of the taxpayer. (R. 17.)

Prior to the merger, three of the operating corporations had sustained net operating losses from their respective businesses as follows: (1) Evanston Libson Shops, Inc., $8,115.11 for the calendar year 1948, and $6,422.28 for the period January 1 to July 31, 1949; (2) Lawrence Libson Shops, Inc., $2,770.42 for its fiscal year ended July 31, 1949, and an unused carry-over credit of $245.03; (3) Hampton Libson Shops, Inc., $4,879.92 for its fiscal year ended July 31, 1949. (R. 16.) In the year following the merger (the taxable year here involved, ended July 31, 1950), each of the businesses formerly operated by these three corporations continued to sustain a net operating loss. (R. 16–17.)

In its income tax return for the first taxable year after the merger, ended July 31, 1950, taxpayer reported a net income of $46,794.70. From this figure it claimed a deduction, by way of carry-over, of the

total net operating losses ($22,432.76) sustained before the merger by three of the operating corporations, as set forth above. (R. 16–17.)

The Commissioner disallowed the claimed deduction, and taxpayer paid the resulting tax deficiency. (R. 14.) Taxpayer duly filed a claim for refund, which was disallowed, and then instituted the present litigation. (R. 17–18.) The District Court held that the claimed net operating loss deduction was not permissible under Sections 23 (s) and 122 of the Internal Revenue Code of 1939, and accordingly sustained the Commissioner's disallowance of the deduction. (R. 33–41.) The Court of Appeals affirmed. (R. 47–60.)

SUMMARY OF ARGUMENT

Taxpayer corporation claims the right, under Sections 23 (s) and 122 of the Internal Revenue Code of 1939, to carry over and deduct from its income for the taxable year here involved net operating losses sustained in prior years by three other corporations merged into it. The assets and liabilities of the three corporations which sustained the losses, together with the assets and liabilities of thirteen other operating corporations (in all, sixteen separate stores), were transferred to the taxpayer corporation pursuant to the merger. After the merger, the three ailing businesses continued to have losses, while those formerly conducted by the other merged corporations continued to have profits, resulting in a net income from all of the businesses combined. The decision below, sustaining the Commissioner's disallowance of the claimed

carry-over, is supported by the terms of the statute, its legislative history, and the controlling precedents.

Section 122 authorizes "the taxpayer" to carry over and deduct from the income of a current taxable year a net operating loss sustained in a preceding year. It is to be strictly construed not only because it grants a tax deduction, but because it marks a sharp departure from the annual accounting rule. The provisions of the statute, their legislative history, and the relevant decisions make it clear that the carry-over privilege is not available unless two conditions are met: (1) The one claiming the privilege must be the same "taxpayer", *i. e.*, the same taxable entity, as the one which sustained the prior year's loss; and (2) there must be continuity of the business enterprise, *i. e.*, the current year's income against which the taxpayer seeks to offset the prior year's loss must be derived from the operation of substantially the same business as that which produced the loss. As the courts below held, neither of those conditions has here been met.

That taxpayer corporation is not the same "taxpayer" as the transferor corporations which were merged into it, follows from the established doctrine of corporate entity—which requires recognition of every corporation for federal income tax purposes—and this Court's decision in *New Colonial Co.* v. *Helvering*, 292 U. S. 435, applying that doctrine in interpreting a statutory provision similar in all material respects to that here involved. In *New Colonial*, this Court held that a corporation which acquired the

assets and liabilities of another corporation pursuant to a reorganization was not entitled to carry over and deduct the transferor corporation's loss because the two corporations were not the same "taxpayer" within the purview of the statute, and it so held notwithstanding the fact that the business and stockholders of each remained the same. The rationale of *New Colonial* (and of cases following it) applies to a merger type of reorganization, such as was here effected.

The cases relied upon by taxpayer, insofar as they hold that a corporation resulting from a merger is the same taxpayer as its dissolved predecessors for purposes of applying the net operating loss provisions of the federal taxing statute, run counter to this Court's reasoning in *New Colonial* and are based upon an untenable distinction between merger and non-merger types of reorganization. Since taxpayer is not the corporation which sustained the operating loss in question, it is no more entitled to the benefit of the carry-over privilege than was the successor corporation in *New Colonial*. Decisions allowing a corporation resulting from a merger to deduct unamortized discount on bond indebtedness (*e. g., Helvering* v. *Metro. Edison Co.*, 306 U. S. 522), also relied upon by taxpayer, deal with post-merger losses sustained by the successor corporation itself; they are not inconsistent with the *New Colonial* decision, and they furnish no authority for the proposition that the net operating loss carry-over privilege is assignable from one corporate taxpayer to another by way

of merger. Nor is there any inconsistency, as taxpayer charges, between the Government's position in this case and in others involving the same question.

Even assuming *arguendo* that the loss carry-over privilege may be extended to a corporation other than the one which sustained the loss, taxpayer still cannot prevail since it has not met the continuity of enterprise test. That test has been applied in the very cases relied upon by taxpayer, and taxpayer's failure to satisfy the requirement serves to distinguish this case from those. Here, the taxpayer corporation acquired the assets of three separate retail stores whose businesses were unprofitable, combined them with those of thirteen other stores whose businesses were profitable, and now seeks to offset against the profits of the new combined enterprise the losses sustained by the three losing ventures.

What is more, each of the three ailing businesses whose losses taxpayer now seeks to carry over and deduct from the income of the new enterprise continued to have losses during the taxable year, so that in the absence of the merger there admittedly would have been no right to a loss carry-over. Thus even if, as taxpayer contends, it stands in the shoes of the merged corporations, it would not be entitled to the claimed deduction. In effect, taxpayer is seeking, solely by virtue of the merger, to create a right to a net operating loss deduction which would not otherwise have existed. It is clear that Congress did not intend such a result.

ARGUMENT

THE COURTS BELOW CORRECTLY HELD THAT TAXPAYER CORPORATION IS NOT ENTITLED TO DEDUCT FROM ITS OWN INCOME FOR THE TAXABLE YEAR HERE INVOLVED NET OPERATING LOSSES SUSTAINED IN PRIOR TAXABLE YEARS BY OTHER CORPORATIONS WHICH WERE MERGED INTO IT

The taxpayer is a Missouri corporation orginally organized in 1946 to supervise and manage other corporations, owned by the same stockholders, which operated clothing stores in Missouri and Illinois. On August 1, 1949, the operating corporations—sixteen in number—were merged into taxpayer, pursuant to the laws of Missouri and Illinois; and taxpayer continued to operate, as a single enterprise, the stores theretofore separately operated by the merged corporations. Before the merger, three of the operating corporations had sustained net operating losses; and the businesses of these corporations continued to operate at a loss after taxpayer acquired them through the merger proceedings. Taxpayer, however, reported an over-all net income for the year succeeding the merger, and the question presented by this litigation is whether it is entitled to carry over and deduct from that net income, under Sections 23 (s) and 122 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 48–50), the pre-merger net operating losses of the three ailing enterprises.

Both the District Court and the Court of Appeals have ruled that taxpayer is not entitled to the deduction, and we submit that their decision is correct. Only the taxpayer who actually sustains a net operating loss is entitled, under the relevant statutes and de-

cisions, to deduct that loss, by way of carry-over or carry-back, in computing his taxable income for years other than the year of loss. The taxpayer corporation in the case at bar is not the same taxpayer which sustained the net operating losses in question, and the claimed deduction has therefore been properly denied.

Alternatively, it is the Government's position that, even if the statute may properly be read as according the carry-over privilege to a taxpayer other than the one who sustained the loss, in any event it may not be construed as extending the privilege to one who carries on a business different from that which produced the loss. Here sixteen separate operating corporations conducting sixteen separate stores were merged into the taxpayer corporation, so that the business thereafter carried on was substantially different; yet taxpayer is attempting to deduct the pre-merger losses of three of the stores from the post-merger income of all of the stores combined. Indeed, since these three stores continued to operate at a loss after the merger, taxpayer is here claiming a tax benefit to which it concededly would not have been entitled in the absence of merger.

A. SINCE TAXPAYER CORPORATION IS NOT THE TAXABLE ENTITY WHICH SUSTAINED THE LOSSES, IT IS NOT ENTITLED TO CARRY OVER AND DEDUCT THE LOSSES

1. *Under Sections 23 (s) and 122 of the 1939 Code, the deduction of a net operating loss by way of carry back or carry-over is available only to the same taxpayer who sustained the loss*

Section 23 (s) of the Internal Revenue Code of 1939 authorizes a "net operating loss deduction computed under section 122." Section 122 in turn provides that

if "the taxpayer" has a net operating loss for a designated taxable year, the loss (with certain adjustments) may be carried back as a deduction against income earned in the two preceding years, and, to the extent not exhausted by the carry-back, be carried over as a deduction against income earned in the three succeeding years.[1]

The provisions of Section 122 must be examined in the light of the "now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, 593. See also *McDonald* v. *Commissioner*, 323 U. S. 57, 60; *Commissioner* v. *Flowers*, 326 U. S. 465; *Deputy* v. *duPont*, 308 U. S. 488, 493. For "only as there is clear provision therefor can any particular deduction be allowed." *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440. See, also, the recent decision in *United States* v. *Olympic Radio & Television*, 349 U. S. 232, where this Court stated (p. 236):

> But as we have said before, "general equitable considerations" do not control the question of

[1] Determination of the net operating loss deduction involves three steps. The first is the computation of the net operating loss, if any, for the years preceding or succeeding the current taxable year. (Section 122 (a) and (d).) The second is the determination of the extent to which the losses may be used as a carry-over or carry-back to the current taxable year. (Section 122 (b).) The third step is the conversion of the aggregate of the permissible carry-overs and carry-backs into the net operating loss deduction. (Section 122 (c).) See Treasury Regulations 111, Section 29.122–1 (Appendix, *infra*, p. 50); *Reo Motors* v. *Commissioner*, 338 U. S. 442, 446–447.

> what deductions are permissible. *Deputy* v. *duPont, supra,* at 493. It may be that Congress granted less than some thought or less than was originally intended. We can only take the Code as we find it and give it as great an internal symmetry and consistency as its words permit.

This rule of strict construction takes on added significance here, since the allowance of a loss carry-over from one taxable year to another, for deduction purposes, marks a sharp departure from our established system of annual tax accounting periods. *Security Mills Co.* v. *Commissioner,* 321 U. S. 281; *United States* v. *Lewis,* 340 U. S. 590; *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359; *Heiner* v. *Mellon,* 304 U. S. 271.

Nothing in the language of Section 122 suggests that Congress intended to permit one taxpayer to carry over (or carry back) and deduct operating losses of another taxpayer. Far from authorizing such a transfer, the language of the section would seem plainly to exclude it. Section 122 (b) (2) (C), the subsection invoked by taxpayer in the instant case, permits carry-over of a net operating loss from one year to another "[i]f * * * the taxpayer" sustained the loss. Thus the only "taxpayer" authorized to carry over a loss of a preceding taxable year and offset it against the income of a current taxable year is "the" taxpayer who had the loss.

Square authority for this interpretation is found in *New Colonial Co.* v. *Helvering, supra,* where this Court construed and applied the carry-over provision of the 1921 Revenue Act (c. 136, 42 Stat. 227, Section

204 (b)), which, in all material respects, was the same as the statutory provision here involved. The Court stated (pp. 440–441):

> The statutes pertaining to the determination of taxable income have proceeded generally on the principle that there shall be a computation of gains and losses on the basis of a distinct accounting for each taxable year; and only in exceptional situations, clearly defined, has there been provision for an allowance for losses suffered in an earlier year. *Not only so, but the statutes have disclosed a general purpose to confine allowable losses to the taxpayer sustaining them, i. e., to treat them as personal to him and not transferable to or usable by another.*
>
> * * * * *
>
> When section 204 (b) is read with the general policy of the statutes in mind, as it should be, we think it cannot be regarded as giving any support to the deduction here claimed. It brings into the statutes an exceptional provision declaring that where for one year "any taxpayer has sustained a net loss" the same shall be deducted from the net income of "the taxpayer" for the succeeding taxable year; and, if such loss be in excess of the income for that year, the excess shall be deducted from the net income for the next succeeding taxable year. Its words are plain and free from ambiguity. *Taken according to their natural import they mean that the taxpayer who sustained the loss is the one to whom the deduction shall be allowed. Had there been a purpose to depart from the general policy in that regard, and to make the right to the deduction transferable or available to others than the*

> *taxpayer who sustained the loss, it is but reasonable to believe that purpose would have been clearly expressed. And as the section contains nothing which even approaches such an expression, it must be taken as not intended to make such a departure.* [Emphasis added.]

The provisions of Section 122, like those of Section 204 (b) of the 1921 Act, must be read in the light of the general policy of the statutes "to confine allowable losses to the taxpayer sustaining them, i. e., to treat them as personal to him and not transferable to or usable by another." And there is obviously no clear expression in Section 122 of a purpose to depart from that general policy. To the contrary, the section focuses upon "the taxpayer"—both as to the computation of net operating losses, and as to the carry-back and carry-over of such losses for deduction purposes. It follows that only "the taxpayer" sustaining the net operating loss can deduct it, by way of carry-back or carry-over, from the income of years other than the year of loss.

This conclusion is supported not only by the *New Colonial* decision but by the pertinent legislative history. The privilege of carrying over a net operating loss from one year to another was first allowed by Section 204 of the Revenue Act of 1918, c. 18, 40 Stat. 1057. The Senate Committee Report accompanying the 1918 bill stated (S. Rep. No. 617, 65th Cong., 3d Sess., p. 7 (1939–1 Cum. Bull. (Part 2) 117, 121–122)):

> At the present time no recognition is given to net losses; that is, if in any year the losses and expenses of a taxpayer exceed his gross in-

come the excess (or in other words, the net loss) can not be carried over into the next year. For purposes of taxation the settlement must be made upon the basis of each year's business by itself. The chief merit of the present plan is its simplicity of administration. But it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice. The committee has accordingly incorporated an amendment (section 204) which provides that under certain limitations net losses sustained in 1917 or in 1918 may be deducted in computing the net income of the taxpayer for the succeeding taxable year; that a net loss sustained in the future may be deducted from the net income of the preceding taxable year, and if it is in excess of the net income for such preceding taxable year, that such excess may be allowed as a deduction in computing the net income for the succeeding taxable year.

A net loss carry-over and carry-back were also allowed in the 1921, 1924, 1926 and 1928 Revenue Acts. Sections 23 (s) and 122 were added to the 1939 Code by Section 211 of the Revenue Act of 1939, c. 247, 53 Stat. 862, in order to restore the relief as it had existed under the 1928 Act. The committee report bearing upon the addition of Sections 23 (s) and 122 contained the following explanation (H. Rep. No. 855, 76th Cong., 1st Sess., pp. 9–10 (1939–2 Cum. Bull. 504, 510–511)):

> The bill, together with the committee amendments, permits taxpayers to carry over net operating business losses for a period of two years. Prior to the Revenue Act of 1932, such

> 2-year carry-over was allowed. * * * In the Revenue Act of 1932, the 2-year net loss carry-over was reduced to one year and in the National Industrial Recovery Act the net loss carry-over was entirely eliminated. As a result of the elimination of this carry-over, a business with alternating profit and loss is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms is equal. New enterprises and the capital-goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carry-over will greatly aid business and stimulate new enterprises.

As originally added to the 1939 Code, Section 122 provided for the computation and carry-over of net operating losses without expressly relating them to a given taxpayer. But Section 153 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, amended Section 122 (b), not only to allow loss carry-backs for the first time, but also to provide, as to both carry-backs and carry-overs, that it was the net operating losses of "the taxpayer" which could be so utilized.

In the light of this history, it is apparent that the loss carry-over privilege allowed by Section 122 and its predecessors was intended to permit a taxpayer whose business income fluctuated widely from year to year to average the income over a period of years, and thereby alleviate the occasional harsh effect of computing his income on an annual accounting basis. There was no intention, express or implied, to permit the averaging of business incomes of different taxpay-

ers. Congress authorized a deduction personal to a given taxpayer and nontransferable to any other taxpayer, as this Court held in *New Colonial Co. v. Helvering, supra.*

Congress apparently accepted this Court's 1934 decision in *New Colonial* as a correct interpretation of the statute, for it made no change in the net operating loss provisions insofar as they affect the question here presented. That Congress did not intend the Section 122 relief to apply generally in favor of a corporation acquiring the assets and liabilities of another corporation through a merger or other reorganization is affirmatively shown, moreover, by the fact that in 1947 it retroactively granted such relief *limited* to certain reorganized railroad corporations. Section 1 of the Act of July 15, 1947, c. 249, 61 Stat. 324. Significantly, the explanatory committee report stated (H. Rep. No. 624, 80th Cong., 1st Sess., p. 1):

> Under existing law, if a railroad corporation is reorganized in a receivership proceeding or in a proceeding under section 77 of the National Bankruptcy Act, as amended, *and the reorganization is effected through the organization of a new corporation,* any carry-overs of net operating losses or unused excess profits credits of the old corporation cannot be used by the new corporation. *The reorganized corporation is regarded as a different taxpayer from the old corporation.* Consequently, railroads coming out of receivership or bankruptcy proceedings are treated differently, *depending upon whether they can be reorganized under the same charter or under a new charter.* The bill removes this discrimination * * * and *the*

> *relief is limited* to railroad corporations as defined in section 77m of the National Bankruptcy Act. [Emphasis added.]

Thus, in clear terms, Congress recognized that a corporation emerging from a reorganization with a "new charter" is not the same taxpayer as its predecessor for purposes of applying the loss and credit carry-over provisions of the statute. Had Congress regarded a corporation acquiring the assets of a predecessor corporation as the same taxpayer for purposes of Section 122, there obviously would have been no need for the enactment of the 1947 statute. And since the special relief granted in 1947 was expressly limited to certain acquiring railroad corporations, it may not be extended by implication to other classes of acquiring corporations.

Enlargements of the relief allowed in Section 122 should be made by Congress, not by the courts. Congress was fully aware that the assets and liabilities of one corporation are often taken over by another corporation pursuant to a merger or consolidation or other kind of reorganization, resulting in termination of the separate corporate existence of the transferor.[2] Had Congress wished to extend the carry-over privilege accorded by Section 122 to a corporation which did not itself experience the net operating loss, but which acquired the business of another corporation which had the loss, it could readily and simply have

[2] Elsewhere in the 1939 Code Congress enacted elaborate provisions respecting the consequences flowing from corporate reorganizations, and it defined a reorganization as including statutory mergers or consolidations. Section 112 (b) (3), (b) (4) and (g) (26 U. S. C. Sec. 112 (b) (3), (b) (4) and (g)).

done so. It did do so—but with well-defined qualifications and limitations—in the Internal Revenue Code of 1954 which, of course, is not applicable to the case at bar.[*]

[*] Section 381 of the Internal Revenue Code of 1954, applicable to years after 1953, permits a successor corporation in a tax-free reorganization to carry over various tax benefits (including a net operating loss) which would have been available to the predecessor, provided certain enumerated conditions are met. Companion Section 382 places "Special Limitations on Net Operating Loss Carryovers," even where the conditions specified in Section 381 are met. The Ways and Means Committee report accompanying the 1954 Code states in part with reference to these sections (H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 41–42 (3 U. S. C. Cong. & Adm. News (1954) 4017, 4066–4067):

"Present law makes no provision for the transfer from one corporation to another, in a tax-free merger or consolidation, of the major tax benefits, privileges, elective rights, and obligations which were available to the predecessor. These include such items as loss carryovers, * * *.

* * * * *

"The bill provides for the carryover of about 16 specific tax attributes or items from one corporation to another in certain tax-free reorganizations, * * *.

"* * * At the same time the new provision makes it difficult to escape the tax consequences of the law by means of a legal artifice such as liquidation and reincorporation or merger into another corporation."

See also pages A135–A145 of H. Rep. No. 1337, *supra* (3 U. S. C. Cong. & Adm. News (1954) 4017, 4273–4284); S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 52–53, 275–287 (3 U. S. C. Cong. & Adm. News (1954) 4621, 4683–4684, 4914–4925); H. Conference Rep. No. 2543, 83d Cong., 2d Sess., pp. 39–41 (3 U. S. C. Cong. & Adm. News (1954) 5280, 5298–5301). Contrary to taxpayer's assertion (Br. 6, 18), it is far from clear that the deduction in controversy would have been allowable under the 1954 Code. But even assuming that it were, there is no basis for taxpayer's further assumption that the 1954 Code confirmed, rather than changed, the pre-existing law. The committee reports caution that "No inference is to be drawn from the enactment of this section [Section

In sum, under the statutory provisions which control this case, the taxpayer corporation can carry over and deduct the net operating losses in question only if it was "the taxpayer," *i. e.*, the same taxable entity which sustained those losses.

2. *Taxpayer corporation is not the same taxpayer as the predecessor corporations whose losses it seeks to carry over and deduct*

The doctrine of corporate entity—that every corporation is a separate taxable unit—forms an integral part of the federal income tax system. Sections 13 (b) and 15 (b) of the Internal Revenue Code of 1939 impose a normal tax and surtax, respectively, upon the net income of "every corporation," and (with exceptions not here relevant[4]) "every corporation" subject to tax is required by Section 52 (a) to file a return depicting its gross income and deductions. See, also, Sections 29.52–1 of Treasury Regulations 111. No exception is made in the case of a merger, consolidation, or other type of reorganization. Furthermore, any taxpayer not in existence during the whole of an annual accounting period is required by Section 47 (g) to file a return "for the fractional part of the year during which the taxpayer

381] whether any item or tax attribute may be utilized by a successor or a predecessor corporation under existing law." H. Rep. No. 1337, *supra*, p. A135; S. Rep. No. 1622, *supra*, p. 277. At any rate, since the 1954 Code provisions are not applicable, there is no need to inquire whether the conditions precedent to the carry-over there imposed are met in this case, or, if met, to ascertain the limited extent to which the losses might be deductible.

[4] See, *e. g.*, the provisions of Section 141 relating to consolidated returns.

was in existence." These provisions have always been recognized as demanding separate returns by a predecessor and successor corporation (including those participating in a merger) of their respective incomes for the periods covering their respective lives. A transfer by way of merger or other reorganization does not have the effect of amalgamating the separate taxable entities of the transferor and transferee corporations.[5]

The doctrine of corporate entity requires recognition of every corporation as a separate taxable entity, so long as it has some business purpose.[6] Thus this Court said in *Moline Properties* v. *Commissioner*, 319 U. S. 436, 438–439:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on

[5] Indeed, in the instant case, taxpayer and its predecessors regarded themselves as separate taxable entities, despite the merger, since separate returns for a short taxable year ending with the merger (July 31, 1949) were filed on behalf of those predecessors which had been filing returns on a calendar year basis. (R. 16.) If, as taxpayer now contends, the taxable identity of the predecessors was continued in it as successor, then a single return covering the calendar year 1949 and reflecting their combined operations for that year should have been filed. See *New Colonial Co. v. Helvering*, 66 F. 2d 480, 481–482 (C. A. 2d), affirmed, 292 U. S. 435.

[6] The rule may be disregarded only where there is an express legislative exception, or where the corporate form is a sham or unreal. *Higgins* v. *Smith*, 308 U. S. 473, 477–78; *Gregory* v. *Helvering*, 293 U. S. 465.

> of business by the corporation, the corporation remains a separate taxable entity. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 442; *Deputy* v. *duPont*, 308 U. S. 488, 494. In *Burnet* v. *Commonwealth Improvement Co.*, 287 U. S. 415, this Court appraised the relation between a corporation and its sole stockholder and held taxable to the corporation a profit on a sale to its stockholder. This was because the taxpayer had adopted the corporate form for purposes of his own. The choice of the advantages of incorporation to do business, it was held, required the acceptance of the tax disadvantages.

This doctrine of separate tax identity applies, of course, not only as between the corporation and its stockholders, but as between commonly owned corporations conducting similar businesses. Thus, a parent corporation and its wholly-owned subsidiaries are separate taxpayers; and the parent may not, by any device, report as its own income the income of its subsidiaries. *National Carbide Corp.* v. *Commissioner*, 336 U. S. 422. Similarly, a parent corporation may not deduct its subsidiary's operating deficit. *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590. See also *Commissioner* v. *Phipps*, 336 U. S. 410; *National Securities Corp.* v. *Commissioner*, 137 F. 2d 600 (C. A. 3d), certiorari denied, 320 U. S. 794.

The doctrine of corporate entity comes into play with full force for purposes of applying the net operating loss deduction provisions, as was made clear by this Court in its landmark decision in the *New Colonial* case. There, the taxpayer corporation had taken over all the assets and liabilities of another

corporation in exchange for its stock, pursuant to a reorganization; and the question was whether the taxpayer could deduct, by way of carry-over, a net operating loss of the predecessor corporation. This Court held (1) that only the taxpayer who sustains a net operating loss is entitled to carry over the loss as a deduction; (2) that the taxpayer corporation was *not* the same taxable entity as the predecessor, although it continued to operate the same business and had the same stockholders; and (3) that, accordingly, it was not entitled to carry over the net operating loss of the predecessor. In disposing of the taxpayer's contention that it was the same "taxpayer" as the predecessor corporation, because it had the same assets, stockholders, and business, and was therefore for all practical purposes the same entity, this Court said (292 U. S. at 441–442):

> This is not in accord with the view on which the stockholders and creditors proceeded when the new company was brought into being. They deserted the old company and turned to the new one because they regarded it as a distinct corporate entity and therefore free from difficulties attending the old one. Having sought and reaped the advantages incident to the change, it well may be that they would encounter some embarrassment in now objecting to an incidental and remote disadvantage such as is here in question. But, be this as it may, we are of opinion that in law and in fact the two corporations were not identical but distinct. This was plainly implied in the transfer of the assets and business from one to the other. That transaction was voluntary and contractual, not

by operation of law. Thereafter neither corporation had any control over the other; the old corporation had no interest in the assets or business, and the chance of gain and the risk of loss were wholly with the new one. Thus the contention that the two corporations were practically the same entity and therefore the same taxpayer has no basis, unless, as the petitioner insists, the fact that the stockholders of the two corporations were substantially the same constitutes such a basis.

As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems. * * * in this case we find * * * nothing taking it out of the general rule. On the contrary, we think it a typical case for the application of that rule.[7]

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[7] To be sure, as taxpayer stresses (Br. 29–31), this Court in *New Colonial* observed that the transfer of the assets and liabilities from the old to the new corporation in exchange for the latter's stock "was voluntary and contractual, not by operation of law." But the transfer here involved was likewise voluntary and contractual, having been based upon an "Agreement" for statutory merger. (R. 15.) Indeed, the intercorporate reorganization transfer effected in this case was no different in substance from that which occurred in *New Colonial;* in both cases all the assets and liabilities of one corporation were voluntarily transferred to another in exchange for the stock of the transferee, which was distributed to the transferor's stockholders, and thereafter the transferor transacted no business and had no income. See 292 U. S. at 437–438. In any event, as is plain from a reading of the entire opinion in *New Colonial*, a net operating loss is not transferable from one corporation to another by any form of consensual arrangement, *i. e.* (*id.*, p. 439), "by deliberate elimination of the old company and substitution of the new one."

A like decision had been reached earlier by the First Circuit in *Athol Mfg. Co.* v. *Commissioner,* 54 F. 2d 230, in which one corporation had similarly taken over the assets, liabilities, and business of another in a reorganization. And since 1934, when *New Colonial* was decided, many cases have denied carry-over or carry-back on similar facts, and on the same rationale: that one corporation is not and cannot be the same taxpayer as another. *E. g., Brandon Corp.* v. *Commissioner,* 71 F. 2d 762 (C. A. 4th); *May Oil Burner Corp.* v. *Commissioner,* 71 F. 2d 644 (C. A. 4th); *Cem Securities Corp.* v. *Commissioner,* 72 F. 2d 295 (C. A. 4th); *Shreveport Producing & Refining Co.* v. *Commissioner,* 71 F. 2d 972 (C. A. 5th), certiorari denied, 293 U. S. 616; *Pennsylvania Co., Etc.* v. *Commissioner,* 75 F. 2d 719 (C. A. 3d); *Weber Flour Mills Co.* v. *Commissioner,* 82 F. 2d 764 (C. A. 10th); *Standard Paving Co.* v. *Commissioner,* 13 T. C. 425, affirmed, 190 F. 2d 330 (C. A. 10th), certiorari denied, 342 U. S. 860;[8] *Common-*

[8] In *Standard Paving* (which involved a claimed carry-back instead of carry-over) the Tenth Circuit declared that (p. 333) "A corporation being a separate legal entity, its net earnings, whether ascertained or not, belong to it," and went on to hold (pp. 333–334):

"To entitle a taxpayer to deductions in income tax liability, it must bring itself clearly within the statutory provisions. *White* v. *United States,* 305 U. S. 281, 292 * * *. This we think the taxpayer here has failed to do. Oklahoma Standard, an entity separate from its successor, ceased to exist upon the date of dissolution. It is a basic concept of taxation that the only person who can take a net operating loss deduction is the taxpayer who sustained the loss and therefore a successor corporation is not entitled to deduct the losses of its predecessor even

wealth Title Co. v. *Rothensies*, 124 F. Supp. 274 (E. D. Pa.); *Follansbee Steel Corp.* v. *United States*, 109 F. Supp. 635 (W. D. Pa.); *Donohue* v. *United States*, 112 F. Supp. 660 (E. D. Mo.); *Newmarket Manufacturing Co.* v. *United States*, 130 F. Supp. 706 (D. Mass.), reversed, 233 F. 2d 493 (C. A. 1st); *Trinco Industries* v. *Commissioner*, 22 T. C. 959; *California Casket Co.* v. *Commissioner*, 19 T. C. 32; *E. & J. Gallo Winery* v. *Commissioner*, decided April 17, 1953 (1953 P-H T. C. Memorandum Decisions, par. 53, 131), reversed, 227 F. 2d 699 (C. A. 9th).

There is no need to join in taxpayer's discussion (Br. 10–14) of the effect of a merger or other type of corporate reorganization under the Missouri and Illinois laws. It suffices that the laws of those states do not purport to erase, or to deny recognition to, the separate prior existences of the transferor and transferee corporations, and that they do not purport to authorize a deduction by one of the corporations of net operating losses sustained by the other for purposes of computing their respective federal income tax liabilities.[9] Moreover, even if a state through its leg-

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though it had assumed all of the liabilities of the predecessor. [Citing *New Colonial Co.* and many other decisions.] * * * We think the rule applies conversely, which would prohibit Oklahoma Standard from deducting losses sustained by Delaware Standard."

[9] Even under state law the successor corporation in a statutory merger or consolidation is not the same entity, in all respects, as its predecessor or predecessors; otherwise the reorganization would have accomplished nothing. Indeed, it is only because the merger or consolidation will effect some desired change that it is conceived and carried out. As for state laws which provide in

islature or courts attempted to do so, the local law would not be controlling, since the question is manifestly one of federal law governed by the federal taxing statute, and it is clear from the scheme of the federal statute, as well as from the decisions of this Court, that every corporation is a separate unit for purposes of determining its federal income tax liability (including the availability of a net operating loss carry-over under Section 122). It is true that for some limited purposes the federal taxing statute treats a transferee corporation which is a party to a tax-free reorganization (including a merger) as standing in the shoes of a transferor (see, *e. g.*, Sections 113 (a) (7) and 311). It has also been held that, under state merger and consolidation laws which shift the obligations of the transferor corporations to the transferee corporation, the federal tax liabilities of the transferors are shifted in the same manner; and that the transferee, as substituted obligor, may petition for redetermination of deficiencies.[10]

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general terms that the successor corporation in a merger or consolidation shall succeed to the rights, privileges and obligations of the predecessor or predecessors, such provisions must, of course, be read as conferring only what it is within the power of the state to give; that is, rights, privileges and obligations created by the laws of that particular state. As Judge Learned Hand pointed out in his dissent in *Stanton Brewery* v. *Commissioner*, 176 F. 2d 573 (C. A. 2d), such laws cannot be read as creating credits or deduction rights under federal revenue laws, passing with corporate assets, like good will or trademarks.

[10] *Oswego Falls Corp.* v. *Commissioner*, 26 B. T. A. 60, affirmed, 71 F. 2d 673 (C. A. 2d); *Saenger* v. *Commissioner*, 38 B. T. A. 1295; *Bowman Hotel Corp.* v. *Commissioner*, 24 B. T. A. 1193; *Trahern Pump Co.* v. *Commissioner*, 27 B. T. A. 363; *Alaska Salmon Co.* v. *Commissioner*, 39 B. T. A. 455.

But these decisions, while they speak of the successor corporation as "the taxpayer" with respect to the tax liabilities of its predecessors, do not stand for the proposition that the former is to be treated as the same taxable entity as the latter for all purposes. To the contrary, they recognize that the successor corporation is to be so viewed solely for the purpose of enforcement or redetermination of the surviving tax liabilities. It hardly follows, as taxpayer apparently assumes (Br. 14–16), that Congress meant to treat the successor corporation and its predecessors as one and the same "taxpayer" for the purposes of applying the net operating loss carry-over privilege afforded by Section 122.[11] In *New Colonial*, this Court flatly held otherwise.

Certainly, a corporation which acqured a business by transfer from an individual stockholder would not be entitled to carry over and deduct from its own income an operating loss sustained in an earlier year by the stockholder, for the simple reason that the transferor stockholder and transferee corporation are separate taxable entities. Similarly, an estate which acquires a business from a decedent (by testamentary transfer or by operation of intestacy laws) clearly would not be entitled to carry over and deduct from its income an operating loss sustained in an earlier year by the decedent, since the decedent and his estate

[11] "It is well to remember that the concepts employed in construing one section of a statute are not necessarily pertinent when construing another with a distinguishable background." *Rohmer v. Commissioner*, 153 F. 2d 61, 65 (C. A. 2d), certiorari denied, 328 U. S. 862.

are likewise separate taxable entities. No valid reason appears, and none is suggested by taxpayer, for reaching an opposite result in the case of intercorporate transfers effected by way of a merger or other type of reorganization. In the latter situation, no less than in the former, the transferor and transferee are different taxable entities and consequently are not the same "taxpayer" within the meaning of the net operating loss deduction provisions.

3. *Taxpayer corporation is not the same taxable entity as its predecessors merely because it acquired the predecessors' assets by a merger rather than through some other type of reorganization.*

Relying chiefly upon *Stanton Brewery* v. *Commissioner*, 176 F. 2d 573 (C. A. 2d), and cases following it,[12] taxpayer takes the position that the doctrine of corporate entity does not apply in the case of a reorganization transfer which takes the form of a merger. It argues that, by virtue of the laws of the states under which the instant merger was effected, a transferee corporation resulting from the merger succeeds by operation of law to all of the rights and obligations of the merged transferor, including deduction rights created by Congress for federal income tax purposes; and that consequently the transferee corporation must be deemed the same "taxpayer" as the transferor within the meaning of the net operating loss provisions

[12] *E. & J. Gallo Winery* v. *Commissioner*, 227 F. 2d 699 (C. A. 9th); *Koppers Co.* v. *United States*, 134 F. Supp. 290 (C. Cls.); *Newmarket Manufacturing Co.* v. *United States*, 233 F. 2d 493 (C. A. 1st). Petitions for certiorari are pending in the *Koppers* and *Newmarket* cases, Nos. 215 and 216.

of the federal taxing statute, entitled to carry over and deduct from its own income a net operating loss sustained by the transferor corporation in a prior year. We respectfully submit that the *Stanton* case was incorrectly decided; that the strong dissenting opinion of Judge Learned Hand represents the correct view; that the Tax Court has properly declined to follow *Stanton*,[13] as have both courts below; and that, in any event, the *Stanton* case is distinguishable from this case.

Stanton dealt with the merger of an operating and a holding corporation, and it was held that the successor corporation could carry over and deduct an unused excess profits credit of the operating corporation. The majority of the court so held on the theory that, since the successor corporation became directly liable under the state (New York) law for outstanding debts of the transferor (merged) corporation, including tax indebtedness, it should be deemed to be the same "taxpayer" as the transferor for purposes of applying the carry-over provisions. It reasoned that the successor corporation was a "union of component corporations into an all-embracing whole which absorbs the rights and privileges, as well as the obligations, of its constituents" by operation of state

[13] *California Casket Co.* v. *Commissioner*, 19 T. C. 32; *Trinco Industries* v. *Commissioner*, 22 T. C. 959; *E. & J. Gallo Winery* v. *Commissioner*, decided April 17, 1953 (1953 P-H T. C. Memorandum Decisions, par. 53,131), reversed, 227 F. 2d 699 (C. A. 9th); *Standard Paving Co.* v. *Commissioner*, *supra*. See also the opinion of the District Court in the *Newmarket* case, *supra*, reported at 130 F. Supp. 706 (D. Mass.).

law (p. 575), and consequently was "'the taxpayer' now obligated to pay their taxes and entitled to their credits" under the federal taxing statute (p. 576).

The reasoning of the majority of the court in *Stanton* is vulnerable in at least three important respects. First, by treating the merged corporation and the corporation resulting from the merger as the same "taxpayer", the court disregarded the established rule that every corporation is a separate taxable entity for federal income tax purposes. *New Colonial Co.* v. *Helvering, supra; Moline Properties* v. *Commissioner, supra; National Carbide Corp.* v. *Commissioner, supra.* Secondly, by hinging the meaning of "the taxpayer", as used in Section 122 of the Internal Revenue Code, upon the nature and effect of a merger under state law, the majority disregarded the settled principle that the federal revenue laws should be interpreted "so as to give a uniform application to a nationwide scheme of taxation." *Burnet* v. *Harmel,* 287 U. S. 103, 110; *Lyeth* v. *Hoey,* 305 U. S. 188, 194; *United States* v. *Pelzer,* 312 U. S. 399, 402–403; *Helvering* v. *Stuart,* 317 U. S. 154, 161; *United States* v. *Gilbert Associates,* 345 U. S. 361, 364. "Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law." *Lyeth* v. *Hoey, supra,* p. 194. Nothing in the language of the carry-over provisions involved in the *Stanton* case, or of those involved in the present case, either expressly or by necessary implication, warrants the view that local law is to govern who is "the taxpayer" entitled to carry over

a federal tax credit or loss from one year to another.[14] Thirdly, there is no ground for the further assumption—upon which the majority opinion in *Stanton* also rests—that, because the transferee corporation in a merger becomes obligated by operation of law to pay existing tax debts of the transferor, it necessarily also becomes entitled to carry over and subtract from its own future taxable income any tax credits or deductions which belonged to the transferor.[15] Whether unused income tax credits or benefits belonging to the transferor pass to the transferee and are deductible from its future taxable income is purely a matter of legislative grace, and Congress has not

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[14] Many states do not permit mergers or consolidations at all, while others limit them to domestic corporations. See Schorr, *Taxable Dividends in Reorganization Cases*, New York University Institute on Federal Taxation, Seventh Annual (1948), pp. 507–509. Under taxpayer's interpretation of Section 122, the availability of the net operating loss privilege would vary from state to state, depending on whether a merger is permissible under the local law, and, if permissible, on whether the local law purports to treat tax deduction privileges created by Congress as assignable from one corporate taxpayer to another.

[15] 1939 Code Section 311 imposes upon a "transferee" of a taxpayer's property "liability, at law or in equity," for federal taxes owing by the taxpayer, to the extent of the value of the property received by the transferee. It affords an expeditious method for the collection of taxes whenever a taxpayer by transferring his assets leaves himself without funds to meet his tax liability, by providing a summary procedure for enforcing the transferee's liability at law or in equity. *Phillips* v. *Commissioner*, 283 U. S. 589; *Phillips-Jones Corp.* v. *Parmley*, 302 U. S. 233. The term "transferee" as used in Section 311 includes "the successor of a corporation, a party to a reorganization as defined in section 112" (Section 29.311–1 of Regulations 111); and Section 112 (g) defines a "reorganization" as including "a statutory merger or consolidation."

seen fit in the 1939 Code to extend such tax benefits to a taxpayer's transferee. *New Colonial Co.* v. *Helvering, supra.* As Judge Learned Hand stated in his *Stanton* dissent (p. 578):

> * * * I do not think that it is more consistent with any declared purpose that I can find, to extend the privilege of a "carry-over" to the taxpayer at bar. Indeed, as the decisions cited in my brothers' opinion show, privileges, closely akin in purpose to this, are ordinarily lost by transfers by one corporation to another; and the form of the transfer cannot be important. We have no warrant for supposing that Congress in general regards such credits as parts of a "universitas juris," passing, with the chattels, choses in action and the rest, like good-will or trade-marks.

In any event, the *Stanton* case is distinguishable on its facts. There, the merger involved a single operating corporation and a parent holding corporation. The business carried on by the transferee corporation after the merger was substantially the same as that which had theretofore been carried on by the merged operating corporation, and even without the merger the latter would have been entitled to the claimed deduction—a crucial feature, in the opinion of the majority, in view of its holding (p. 577) that Congress intended the carry-over provisions to apply "to what is essentially a continuing enterprise". Here, sixteen separate operating corporations conducting sixteen separate stores were merged into a seventeenth corporation, so that the business there-

after carried on by the transferee corporation was substantially different. The taxpayer here is seeking to deduct pre-merger losses of three of the stores from the post-merger income of the other stores. Moreover, these three stores continued to operate at a loss after the merger; had the merger never occurred the three taxpayers who sustained the losses would not have been entitled to the carry-over which the transferee-taxpayer here seeks. Thus taxpayer is not asserting a tax benefit which would have existed in the absence of the merger, as was the taxpayer in *Stanton*; it is seeking to create one solely by reason of the merger.

The other cases involving application of the net operating loss provisions (*E. & J. Gallo Winery* v. *Commissioner*, 227 F. 2d 699 (C. A. 9th); *Koppers Co.* v. *United States*, 134 F. Supp. 290 (C. Cls.); *Newmarket Manufacturing Co.* v. *United States*, 233 F. 2d 493 (C. A. 1st)), upon which taxpayer relies, follow the majority opinion in *Stanton*. Like *Stanton*, they proceed upon a combination of two theories: (1) a corporation resulting from a merger is the same corporate entity as the merged corporation; (2) the resulting corporation continued to carry on the same business enterprise as the merged corporation. Insofar as they hold that a transferee corporation in a merger is the same taxable entity as the transferor for purposes of applying Section 122, they derogate from this Court's *New Colonial* decision and rest upon a meaningless distinction between merger and non-merger transfers. As this Court made clear in *New Colonial*, the carry-over privilege does not inure to the benefit

of a reorganization transferee for the simple reason that it is not the same taxable entity as the transferor; and that reason applies equally whether the reorganization is of the merger or non-merger type.[16] And insofar as the cases rest upon the continuing enterprise theory, they are, of course, grounded upon a feature not present here, since taxpayer took over the business of sixteen different operating corporations and not just the business of the corporations whose losses it seeks to carry over and deduct.

The court below properly observed, therefore, that the *Stanton* and *Gallo* cases "stand on the same footing" and are "not persuasive." (R. 58.) The same observation applies to *Koppers,* where the merged corporations had been filing consolidated returns. As for the *Newmarket* case, which also involved a continuing enterprise, it is to be noted that the court there did not disagree with the decision below; on the contrary,

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[16] It is true, as noted in the *Stanton* majority opinion, that application of the corporate entity doctrine may, in some instances, render the availability of the net operating loss deduction dependent upon which of two or more corporations survives a merger or other reorganization. But the corporate entity doctrine, albeit a technical one based upon a fictional distinction between a corporation and its stockholders, plays a vital role in the federal taxing scheme as in other fields, and must be strictly and uniformly applied irrespective of whether it is the taxpayer or the Government whose interests are adversely affected. *Moline Properties* v. *Commissioner, supra; National Carbide Corp.* v. *Commissioner, supra; New Colonial Co.* v. *Helvering, supra.* Besides, a taxpayer is not immune from tax liability on a taxable transaction merely because it might have chosen a non-taxable (or less taxable) method of achieving the same result; tax consequences flow from what the taxpayer does, not from what it might have done. *Founders General Co.* v. *Hoey,* 300 U. S. 268, 275.

it expressly distinguished *Newmarket* from the instant case, and ruled (p. 499) in the taxpayer's favor "without intending to go beyond the facts of the case at bar."

Equally misplaced is taxpayer's reliance upon *Helvering* v. *Metro. Edison Co.*, 306 U. S. 522, and cases which led up to that decision. Those cases involved a question far removed from that here presented, namely, whether a corporation resulting from a merger may deduct unamortized discount on bonds issued by the predecessor and assumed by the successor. Nothing in those decisions may be fairly construed as undermining the corporate entity doctrine enunciated in the *New Colonial* case and implemented in the *Moline* and *National Carbide* cases, or as supporting a distinction between merger and non-merger reorganizations for purposes of determining the right of one corporation to carry over and deduct a net operating loss sustained by another.

Prior to *Metro. Edison*, there had been four decisions allowing a successor corporation to deduct unamortized bond discount and expense. In all of these, the courts viewed the bond indebtedness as having been transferred from the predecessor by operation of law as a result of statutory merger or consolidation. *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. 2d 6[illegible] (C. A. 4th); *New York Cent. R. Co.* v. *Commissioner*, [illegible] 2d 247 (C. A. 2d), certiorari denied, 296 U. S. 655; *American Gas & Elec. Co.* v. *Commissioner*, 85 F. 2d 527 (C. A. 2d); and *American Gas & Electric Co.* v. *United States*, 17 F. Supp. 151 (C. Cls.). In *Metro. Edison*, this Court also

found that taxpayer had consummated a merger and it similarly concluded, in harmony with the earlier decisions of the lower federal courts, that the bond indebtedness had been transferred by operation of law. From this, it followed logically that the deduction was permissible. For since there was no consideration for the passing of the obligation to the transferee corporation, the loss was one which would ultimately be sustained *by the transferee*. In *New York Cent. R. Co.* v. *Commissioner*, the Second Circuit had stated the rationale as follows (79 F. 2d at 249):

> The consolidated corporation does not succeed to the rights and liabilities of the constituent companies as a purchaser but as a successor by operation of law. * * * The assets of the consolidated corporation have the same cost basis as they had when held by the old companies, and are subject to the lien of the bond issues. *Hence the consolidated corporation will suffer a loss when it pays the bonds at par* * * *. As already stated, the subject of amortization is the difference between the cash realized on the bonds and their par value. This difference the consolidated corporation will pay when the bonds mature, and this expenditure it should be allowed to anticipate by yearly amortization during the life of the bonds in order more clearly to reflect its income.
>
> The Commissioner argues that allowable deductions are personal to the taxpayer and cannot be transferred to or used by another. *But the cases which announce this doctrine deal with losses sustained by a predecessor and sought to be deducted by a successor.* [Citing *New Colonial* and companion decisions.] * * * *no loss was sus-*

tained by the issuing corporations in selling their bonds at a discount; the loss will be sustained by the consolidated corporation when the bonds mature and are paid. Hence the deductions here in question are by way of anticipation of the taxpayer's own loss and should have been allowed. [Emphasis added.]

Thus, where bond indebtedness is transferred by operation of law, rather than for a consideration, the successor corporation *itself* sustains the unamortized bond discount loss *after* the reorganization, and hence can deduct the loss *as its own*.[17] It is in this context

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[17] The reason for distinguishing between a gratuitous transfer by operation of law and a contractual transfer for a consideration was stated in *Jones* v. *Noble Drilling Co.*, 135 F. 2d 721, 725 (C. A. 10th):

"If the corporate taxpayer acquired the assets of the subsidiary by contract for a stipulated consideration, it would be a reasonable assumption that, in fixing the amount of consideration to be paid, it would give regard to and make due allowance for the bond discount to be assumed and paid by it; whereas, if the obligations were assumed by operation of law, it would have no opportunity so to do."

Put another way in *Athol Mfg. Co.* v. *Commissioner*, *supra*, 54 F. 2d at 231, where the successor corporation contractually assumes the obligations of the predecessor, subsequent payments on the obligations cannot be deductible losses or expenses of the successor, because they are in reality "part of the consideration for the purchase of the assets of the old company; * * * part of the cost to the petitioner of those assets and constituted a capital, not a business, expense." Where the transfer is by operation of law, however, the losses and expenses are sustained *by* the successor *after* the reorganization, and hence are deductible. *New York Cent. R. Co.* v. *Commissioner*, *supra*. As the Court of Claims stated in *American Gas & Electric Co.* v. *United States*, *supra*, 17 F. Supp. at 159:

"The right to claim a deduction on account of having redeemed the bonds at a price above par did not come into existence until

that the Commissioner conceded in *Metro. Edison,* as noted in this Court's opinion (p. 526), that in the case of a merger or consolidation, as contrasted with a sale, "the identity of the corporation issuing the bonds continues in the successor and the latter becomes liable for the debts of the former by operation of law", and that in such situations the successor may deduct losses and expenses attributable to the assumed bond indebtedness. And it is in the same sense, we believe, that this Court concluded in *Metro. Edison* (p. 529):

> We are of opinion that *a transfer without valuable consideration,* with the intent that the transferor shall, as the statute provides, cease to exist, made in accordance with the statute, has all the elements of a merger and comes within the principle that the corporate personality of the transferor is drowned in that of the transferee. It results that the continuing corporation may deduct unamortized bond discount and expense in respect of the obligations of the transferring affiliate. [Emphasis added.]

In short, the bond discount cases upon which taxpayer relies stand merely for the proposition that where the bond indebtedness is transferred "without valuable consideration", so that there has been no adjustment of a purchase price to reflect prospective losses and expenses attributable to the bonds, the successor corporation is to be treated as if it were the issuer of the bonds, and accordingly may deduct the

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the bonds were so redeemed and, as we think, belonged to the corporation making the payment. Clearly it was this corporation that sustained the loss."

future losses and expenses as they are sustained, *after* the merger.

The problem here is not comparable to that presented in the cases involving deductibility of unamortized bond discount, nor do the decisions in those cases depart from the rule of the *New Colonial* case. Taxpayer here is not attempting to deduct a post-merger expense or loss *of its own* arising out of an assumption of a predecessor's bond obligations, as were the taxpayers in those cases. Rather, it is attempting to carry over and deduct pre-merger net operating *losses of three of its predecessors.* As this Court held in *New Colonial,* the taxing statute accords the carry-over privilege only to "the taxpayer" who sustained the loss, not to a transferee. Under that decision the privilege is not assignable from one taxpayer to another, and this is so regardless of whether the purported assignment is made gratuitously, by way of a merger or other corporate reorganization, or for a consideration. Significantly, there is nothing in the opinion of this Court in *Metro. Edison* which even remotely suggests that the Court was departing from its holding in *New Colonial;* indeed, in view of the absence of reference to *New Colonial,* it is apparent that this Court did not consider the issues in the two cases to be analagous.

Taxpayer's failure to distinguish between a post-merger expense of the transferee corporation itself (involved in *Metro. Edison*) and a pre-merger net operating loss of the transferor corporation (involved in *New Colonial* and this case) likewise accounts for its

claim (Br. 7, 21–22) that the Government's position here is inconsistent with an informal administrative ruling contained in P. S. 62 (May 5, 1950, 1950 C. C. H., par. 6118). That ruling was addressed to the question of deductibility of the unamortized portion of an amount paid by an employer corporation under a pension plan to fund the cost of past service credits of the employee-beneficiaries, under the provisions of Section 23 (p) (1) (A) (iii) and (iv) of the Internal Revenue Code of 1939. After the cost had been partially amortized, the employer corporation, pursuant to a merger, transferred its assets and liabilities to another corporation, which assumed the obligations under the pension plan and consequently obligated itself to pay the pensions as they became due. In P. S. 62, the Deputy Commissioner took the view that the problem was analogous to that presented in *Metro. Edison,* rather than to the question in *New Colonial,* and accordingly instructed Internal Revenue agents to allow the transferee corporation to deduct the unamortized cost of the pension plan assumed by it to the same extent that the transferor would have been entitled to do so. Surely, this ruling furnishes no basis for taxpayer's charge of inconsistency.[18] In cases involving the question whether net operating

[18] Even if it were assumed that the view expressed in P. S. 62 is not fully consistent with the contention urged here, that would scarcely be a decisive consideration, particularly since the earlier view did not have the status of a formal Treasury ruling nor reflect an established course of administrative construction. See *Helvering* v. *Southwest Corp.*, 315 U. S. 194, 201, fn. 2; *Helvering* v. *Reynolds*, 313 U. S. 428; *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90.

losses may cross the line of a statutory merger, the Government has consistently urged that they may not and that *New Colonial* controls.[19]

B. EVEN IF REGARDED AS THE SAME TAXABLE ENTITY AS ITS PREDECESSORS, TAXPAYER IS NOT ENTITLED TO THE CLAIMED OPERATING LOSS DEDUCTION SINCE ITS BUSINESS WAS NOT THE SAME

If, as we submit, taxpayer corporation is not the same "taxpayer" as its extinct predecessors, within the meaning of Section 122, then the decision below is entitled to affirmance on that ground alone, and there is no necessity to inquire whether taxpayer has also met the so-called continuity of enterprise test, *i. e.*, whether the income for the taxable year against which it seeks to offset the predecessors' operating losses in prior years was derived from a continuation of the same business as that which produced the losses. However, should this Court hold that taxpayer is to be deemed the same taxable entity as its predecessors, then we submit that the decision below is nevertheless correct on the alternative ground—also relied upon by the court below—that taxpayer's business was substantially different from that of the predecessors.

As is plain from the legislative history of the net operating loss provisions, discussed above (pp. 13–15), the loss carry-over privilege was designed to permit a taxpayer whose business income fluctuated widely

[19] Indeed, the Commissioner has taken the position, albeit unsuccessfully, that even the *same* corporate taxpayer is not entitled to carry over a net operating loss, where the business which gave rise to the loss was not substantially the same as that which produced the income from which the taxpayer sought to deduct the loss. *Alprosa Watch Corp.* v. *Commissioner*, 11 T. C. 240.

from year to year to average the income over a period of years. In substance, the privilege constitutes an exception to the fundamental rule that taxable income is to be computed on an annual accounting basis. It manifestly was never intended to permit the averaging of business incomes of corporations which conduct different businesses. Compare Section 382 (a) (1) (C) of the Internal Revenue Code of 1954, which precludes a carry-over even by the same corporation unless, among other things, the corporation continues to carry on "substantially the same" business as before.

This underlying purpose of the net operating loss carry-over privilege has indeed received recognition in the very cases upon which taxpayer relies. Thus in *Stanton,* upon which it chiefly relies, the court in reaching its decision stressed (176 F. 2d at 577) that the transferor and transferee corporations in the merger carried on "essentially a continuing enterprise, entitled to all their [net operating loss provisions] benefits in ameliorating otherwise harsh tax consequences of fluctuating profits or expanding business." And in *Newmarket,* upon which taxpayer also strongly relies, the court expressly distinguished that case from this one on the ground (233 F. 2d at 497) that there the business and stockholders of the transferor and transferee corporations were the same—"one single business"—whereas in this case there was a merger of "several businesses." Thus, the very considerations which impelled the courts in *Stanton* and *Newmarket*

to allow the claimed deduction—continuity of the enterprise—compel an opposite result in this case by reason of the absence of that feature.[20]

The taxpayer corporation which here claims the right to carry over a previous year's operating loss is not only a different taxpayer from the one which sustained the loss; the income against which it seeks to offset the loss was not even derived from the same business which gave rise to the loss. Here, the assets and liabilities of sixteen separate corporations, each conducting a retail store at a different location and each having a separate profit-loss history, were transferred to another corporation (taxpayer) pursuant to a merger. The business which was thereafter conducted by the transferee corporation—a combination of all of the stores—was substantially different from that previously conducted, when each store was separately owned and operated. Cf. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590. The segregated pre-merger business operations which produced the losses in question had no post-merger counterpart; conversely, the integrated post-merger operations which produced the income against which taxpayer would apply the losses had no pre-merger counterpart. While the several

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[20] The *Koppers* case likewise presented a situation in which the corporation resulting from the merger carried on essentially the same enterprise as before, since the merged corporations had been filing consolidated tax returns. As for *Gallo*, as the court below observed (R. 57–58), the opinion in that case does not disclose "whether or not there was involved a continuing enterprise," and "[a]pparently the *Gallo* and *Stanton* cases stand on the same footing."

corporations were converted into a single entity by virtue of the merger, that entity was neither the same corporate entity nor the same business entity which experienced the pre-merger losses. Only by reconstructing a hypothetical consolidated profit and loss statement of the merged corporations for the pre-merger years and comparing the result with the income for the post-merger year here involved, and by superimposing the further hypothesis that taxpayer and the merged corporations were one and the same taxable entity, can it be said that taxpayer is entitled to the claimed carry-over privilege. To allow the post-merger income of the consolidated enterprise to be offset by pre-merger losses of some of the merged corporations would extend the relief granted by the carry-over provisions far beyond that contemplated by Congress. It would enable taxpayer to reduce its own average business income, which Congress meant to tax, by losses sustained by other taxpayers in other businesses.

Furthermore, to allow the deduction in controversy would produce the anomalous result that losses which the transferor (merged) corporations themselves could not have carried over in the absence of the merger may be carried over by the transferee (taxpayer) corporation solely by reason of the merger. The losses in question could not have been carried over by the merged corporations, even if their separate existences had not been terminated by the merger, since the stores which they respectively operated admittedly continued to sustain losses after the merger and during the tax-

able year here involved. (R. 17.) Thus, taxpayer is not asserting a right to a net operating loss deduction which, but for the merger, would have been available to the transferor corporations that sustained the losses. Rather it is seeking, solely by virtue of the merger, to obtain a deduction unavailable to the transferor corporations themselves. Surely, the merger did not in and of itself serve to create a Section 122 deduction where none existed before. That section was designed to place taxpayers whose business earnings fluctuated from year to year on a tax parity with those having stable annual earnings; it was never intended to accord them an advantage over other taxpayers. Instead of achieving the objective at which Section 122 was aimed, allowance of the deduction in controversy would bestow upon taxpayer a tax windfall.

To subscribe to taxpayer's interpretation of Section 122 would sanction abuse of the relief intended. It would extend the benefits of that section to a corporation which absorbs another corporation with a history of operating losses, with a view to deducting the losses from its own future income. In effect, it would lend judicial approval to the exploitation, for bargaining purposes, of the tax benefits afforded by the net operating loss carry-over provisions.[21] The District Court

[21] The limitation provisions in Sections 381 and 382 of the 1954 Code, relating to net operating loss carry-overs by successor corporations in mergers or other tax-free reorganization, were designed in part to prevent "trafficking in corporations with operating loss carryovers, the tax benefits of which are exploited by persons other than those who incurred the loss." H. Rep. No. 1337, *supra*, pp. 41–42 (3 U. S. C. Cong. & Adm. News (1954), 4017, 4067). See also S. Rep. No. 1622, *supra*, pp. 52–53 (3

had "no doubt" that, whatever other motive taxpayer corporation may have had in acquiring the assets of the three corporations whose stores had sustained operating losses, "use of their tax credits was one."[22] (R. 41.)

Had the loss stores been owned and operated by taxpayer's stockholders and then transferred to taxpayer corporation, the latter unquestionably could not avail itself of the carry-over privilege. No reason appears, nor is any offered by taxpayer, for reaching a different tax result merely because the transferors were corporations rather than individuals. In the one case, as

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U. S. C. Cong. & Adm. News (1954) 4621, 4683–4); H. Conference Rep. 2543, *supra*, pp. 39–40 (3 U. S. C. Cong. & Adm. News (1954) 5280, 5298–5300).

[22] Whether the claimed loss deduction would in any event be barred by Section 129 of the 1939 Code, as added by Section 128 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21, even if it qualified for deduction under Section 122, is of academic importance in this case in the absence of a finding that tax avoidance was the principal purpose of the transfer. Section 129 provides in substance that where any person acquires control of a corporation, or any corporation acquires the property of another corporation (other than one controlled by the same interests) in a tax-free exchange, and the "principal purpose" of the acquisition is tax avoidance through the benefit of a deduction or credit, then the deduction or credit shall not be allowed. Its provisions do not, as taxpayer implies (Br. 33), enlarge the category of allowable deductions, but were intended merely to supplement and extend established safeguards against tax avoidance schemes. H. Rep. No. 871, 78th Cong., 1st Sess., pp. 24, 49–50 (1944 Cum. Bull. 901, 938); S. Rep. No. 627, 78th Cong., 1st Sess., pp. 26, 58–61 (1944 Cum. Bull. 973, 1016–1017). Accordingly, while Section 129 might preclude deduction of a net operating loss which otherwise qualified for deduction under Section 122, it obviously cannot serve conversely to authorize deduction of a loss not otherwise allowable under Section 122.

in the other, the transferors and transferee are separate business and taxable entities. Having chosen for reasons of their own to discard the multiple corporate form as a mode for conducting business, and thereafter to carry on as a single taxable entity, the parties cannot now escape the tax "disadvantage" of that choice. *New Colonial Co.* v. *Helvering, supra,* 292 U. S. at 441. See also *Woolford Realty Co.* v. *Rose,* 286 U. S. 319; *Planters Oil Co.* v. *Hopkins,* 286 U. S. 332; *Trinco Industries* v. *Commissioner, supra.*

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(s) [As added by Section 211, Revenue Act of 1939, c. 247, 53 Stat. 862] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 122 [As added by Section 211, Revenue Act of 1939, supra]. NET OPERATING LOSS DEDUCTION.

(a) [As amended by Section 105 (e) (3) (A). Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [As amended by Section 215, Revenue Act of 1950, c. 994, 64 Stat. 906] *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—

(A) *Loss for Taxable Year Beginning Before 1950.*—If for any taxable year beginning after December 31, 1941, and before January 1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss car-

ry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year * * *.

* * * * *

(2) *Net operating loss carry-over.*—

* * * * *

(C) [As added by Section 330, Revenue Act of 1951, c. 521, 65 Stat. 452] *Loss for Taxable Year Beginning After December 31, 1947, and Before January 1, 1950.*—If for any taxable year beginning after December 31, 1947, and before January 1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the three succeeding taxable years, except that the carry-over in the case of each such succeeding taxable year (other than the first succeeding taxable year) shall be the excess, if any, of the amount of such net operating loss over the sum of the net income for each of the intervening years * * *.

* * * * *

(c) [As amended by Sections 105 (e) (3) (B) and 153 (b) of the Revenue Act of 1942, *supra*, and Section 121 (g) (2) of the Revenue Act of 1950, *supra*] *Amount of Net Operating Loss Deduction.*—The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income

(computed without such deduction and without the credits provided in sections 26 (h) and (i));

* * * * *

(26 U. S. C. 1952 ed., Sec. 122.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.122–1. *Net Operating Loss Deduction*—(a) *General.* (1) Section 122 provides the rules for the computation of the net operating loss deduction allowed by section 23 (s). The net operating loss deduction is the aggregate of the net operating loss carry-overs and carry-backs to the taxable year, reduced by certain adjustments to prevent the deduction of losses absorbed by income not taxed.

* * * * *

(b) [As amended by T. D. 5963, 1953–1 Cum. Bull. 197] *Steps in computation of net operating loss deduction.* There are three steps in the ascertainment of the net operating loss deduction. The first step is the computation of the net operating loss, if any, for any preceding or succeeding taxable year from which a net operating loss may be carried forward or carried back to the current taxable year. The second is the computation of the net operating loss carry-overs to the taxable year from such preceding taxable years and the computation of the net operating loss carry-backs to the taxable year from such succeeding taxable years. The third is the conversion of the aggregate of such net operating loss carry-overs and carry-backs into the net operating loss deduction.

* * * * *